

Appeal from a Decision of the Acting Associate Director for Policy and Management Improvement, Minerals Management Service, denying the appeal of a decision by the Chief, State and Indian Compliance Division. MMS-96-0345-0&G.

Affirmed.

1. Federal Oil and Gas Royalty Management Act of 1982:
Royalties--Oil and Gas Leases: Royalties: Generally

In valuing residue gas or gas plant products sold in an arm's-length transaction for royalty purposes, marketing costs are the obligation of the lessee. A contractual 2-percent deduction from the net-back price constitutes a marketing fee that cannot be deducted from the royalty basis of production when the contract provides that the processor acquires the gas from the lessee/producer for resale, and the lessee does not establish that any part of the 2-percent represents the cost of transportation. When it appears that the sale price reflects the deduction of marketing costs, a decision requiring the lessee to recalculate royalties on the basis of a value which includes the marketing costs will be affirmed on appeal.

APPEARANCES: Tom Kravchak, Revenue Manager, Yates Petroleum Corp., Artesia, New Mexico, for Appellant; Howard W. Chalker, Esq., Geoffrey Heath, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE TERRY

Yates Petroleum Corporation (Yates or Appellant) has appealed from the July 9, 1997, Decision of the Acting Associate Director for Policy and Management Improvement, Minerals Management Service (MMS or Respondent), denying Yates' appeal of a decision by the Chief, State and Indian Compliance Division (SICD).

The facts are undisputed. Yates and Western Gas Processors, Ltd. (Western), entered into an October 1, 1987, "Gas Processing Contract" (Contract), where Western agreed to process and market gas produced by Yates from its Federal oil and gas lease. Western agreed to pay Yates 98 percent "of the net proceeds received by Processor from Producer's Plant Products and drip liquids." See Contract, Art. X, para. 6.

MMS found that the contractual 2-percent deduction from the net-back price was a marketing fee. Accordingly, on August 9, 1996, SICD directed Yates to increase the gross proceeds it had reported by 2-percent when calculating the royalty due on production. Yates appealed that order to the Director, MMS. On July 9, 1997, the Acting Associate Director issued the Decision under appeal here, affirming SICD's previous determination that the 2-percent deduction was a marketing cost that was not deductible from the value of production for the purposes of determining royalty. Yates appealed.

[1] The present situation, as MMS argues in its Answer, amounts to a contractual agreement between Yates and Western under which Western agreed to sell Yates production in return for a 2-percent commission. There is, of course, nothing preventing a lessee from engaging an agent to sell its production. However, a lessee is obligated to pay royalty on the value of the gas. The creation and development of markets for production is the very essence of the lessee's implied obligation to prudently market production from the lease at the highest price obtainable for the mutual benefit of lessee and lessor; traditionally, Federal lessees have borne 100 percent of the costs of developing a market for gas. Taylor Energy Company, 143 IBLA 80, 79 (1998); ARCO Oil & Gas Co., 112 IBLA 8, 11 (1989); Walter Oil & Gas Corp., 111 IBLA 260, 265 (1989). It is the lessee's duty to perform that service at no cost to the lessor. This means that the lessor's royalty is not reduced by the costs of finding a market for the gas, in this case, the 2-percent payment to Western.

Nor can Yates avoid paying royalty on the cost of selling the gas because a third party (Western) performed that duty. It is irrelevant who performs the necessary obligations of a lessee, or that title may have passed from the Federal lessee prior to undertaking an activity the lessee is obligated to perform. See Apache Corp., 127 IBLA 125, 134 (1993). The regulations require Yates to increase the gross proceeds to the extent that they were reduced because Western provided marketing services, as the costs of marketing services are Yates' responsibility as part of its duty to market the gas. See 30 C.F.R. § 206.152(i).

In its Notice of Appeal (NOA), Yates challenges MMS' ruling that the 2-percent reduction is allocated totally for marketing services. Appellant calls it a "marketing fee and transport expense," and argues that the cost of transportation is a deductible expense. (NOA at 2.) Appellant alternatively claims that "the transportation fee in question is a separate and identifiable charge apart from the two percent marketing fee making MMS' argument moot." Id. Further, Yates argues that in denying its initial

appeal, MMS "agreed with Yates that Western's transportation charge for moving gas from the tailgate of the Aneth Plant to the San Juan Plant is a deductible transportation allowance." Id.

In its Answer, MMS reiterated that the July 9, 1997, Decision stated that it appeared that a part of the 2-percent fee was for transportation and that reasonable transportation costs may be deducted from royalty value. (Answer at 2.) But MMS notes that, in its appeal, Appellant claims that the 2-percent fee was only for marketing, and Yates has not provided any detailed transportation costs justifying a deduction. Id., citing NOA at 2.

We must agree with MMS. The language of Article X, paragraph 6 of the 1987 Contract provides that the 2-percent reduction shall be taken from the net, with other "costs and expenses incurred or made in connection with the sale and delivery of the Plant Product or liquid drip" deducted from the total gross proceeds to establish the net. See Contract, Article X, para. 6. These costs deducted from the gross to establish the net cost would, arguably, include reasonable transportation costs.

Transportation costs, like other deductions, must be established by the one claiming the deduction. See Supron Energy Corp., 55 IBLA 318, 322 (1981). In this case, Yates must introduce evidence that would establish its claim. It has not done so despite its contractual right to information related to the cost of transportation to be provided by Western on request. See Contract, Article XXIII, para. 1.

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 C.F.R. § 4.1, the Decision appealed from is affirmed.

James P. Terry
Administrative Judge

I concur:

R.W. Mullen
Administrative Judge